

## Internal Revenue Service

Department of the Treasury  
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Person To Contact:

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Refer Reply To:

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Date:

June 15, 2011

In Re:

### Legend:

Settlor	=
Son	=
Spouse	=
Grandchild A	=
Grandchild B	=
Great-grandchild A	=
Great-grandchild B	=
Great-grandchild C	=
Great-grandchild D	=
Trust	=

Bank	=
Local Court	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
<u>x</u>	=
Stock	=
<u>y</u>	=
State	=
State Statute	=

Dear :

This letter responds to the December 13, 2010 letter and subsequent correspondence from your authorized representative, requesting rulings on the

generation-skipping transfer (GST) and gift tax consequences of the proposed modification of Trust.

The facts submitted and representations made are as follows. On Date 1, Settlor created an irrevocable trust (Trust) for the benefit of the descendants of Settlor's son (Son). On Date 2, Settlor transferred to Trust  $x$  shares of publicly-traded stock (Stock). On a timely filed Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, Settlor reported the Date 2 value of Stock at \$ $y$  and allocated  $y$  of his GST exemption to the Date 2 transfer of Stock to Trust. It is represented that no further additions have been made to Trust and that Trust presently has an inclusion ratio of zero.

Under Item III(a) of Trust, the trustees may distribute to the descendants of Son any amount of income or principal as the trustees deem necessary for the support of any descendant in his or her accustomed manner of living. The trustees may also distribute income or principal, as the trustees deem best, to any charitable or educational organization (Charity) described in § 501(c)(3) of the Internal Revenue Code, to the exclusion of Son's descendants.

Under Items III(c) and (d), upon the death of the survivor of Settlor, Son, and Son's spouse (Spouse), the remaining assets of Trust will be divided, per stirpes, among the surviving descendants of Son, each descendant's share to be held in a separate trust for that descendant's (Primary Beneficiary) primary benefit. The trustees have discretion to distribute any amounts of income and principal of each separate trust to the Primary Beneficiary and that beneficiary's descendants living from time to time for each such individual's support in his or her accustomed manner of living.

Items III(e) and (f) provide that each Primary Beneficiary has a lifetime or testamentary power to appoint any part of that beneficiary's separate trust to any of Son's descendants, excluding the powerholder, the creditors and estate of the powerholder, and the creditors of the powerholder's estate. At the death of a Primary Beneficiary, that beneficiary's trust, to the extent not appointed, will be divided, per stirpes, into separate trusts for that beneficiary's surviving descendants, or, if none, for the specified descendants of Settlor. Each new separate trust will be held for its respective Primary Beneficiary under the terms of Items III(c) through (f).

Under Item III(g), all existing trusts will terminate 21 years after the death of the last to die of all of the descendants of Settlor's father living on Date 1, and the remaining assets of each trust will be distributed to the oldest person then eligible to receive payments from the respective trust.

Item V of Trust provides that whenever the term "descendant" or "descendants" is used in Trust, it will be deemed not to include any legally adopted child.

Under Items IX(a) through (c), Son, Spouse, and Bank are named as trustees. Whenever more than two trustees are serving, the majority decision will control. Upon reaching age 30, each Primary Beneficiary will serve as sole trustee of that beneficiary's trust.

Son currently has two natural children (Grandchild A and Grandchild B). Grandchild A has two natural children (Great-grandchild A and Great-grandchild B). Grandchild B has two natural children (Great-grandchild C and Great-grandchild D). These descendants of Son are the only current beneficiaries of Trust. Settlor's family recently learned that Son's two children are both carriers of a rare and very serious genetic disorder that is passed to successive generations with great frequency and often in a more severe form. When Settlor created Trust, the family did not know the family carried this genetic disorder.

On Date 3, Son and Spouse, as trustees, filed a petition (Petition) in the Local Court asking the court to modify Trust under State Statute, as follows (Proposed Modification). Item V would be modified to provide that whenever the term "descendant" or "descendants" is used in Trust, except as provided in Item III(g), it will be deemed to include any person legally adopted before reaching the age of majority. Item III(g) would be modified to provide that an adopted person is excluded from the definition of the term "descendant" or "descendants" but only for purposes of applying the rule against perpetuities period under Item III(g).

Petition states that Settlor's family has only recently learned its members carry the specific genetic disorder and that, on the advice of medical professionals, one or more of Son's descendants may very well choose not to bear children but, instead, to adopt. Thus, compliance with the current definition in Trust of the term "descendant" or "descendants" would defeat or substantially impair Settlor's purpose in creating Trust, which is "to provide for the support of multiple generations of [Son's] descendants for the [perpetuities period under Item III(g)]."

Petition asks Local Court to appoint a guardian ad litem to represent the minor beneficiaries, Great-grandchildren A through D, and Son's otherwise unrepresented descendants, born and unborn. Petition also asks Local Court to issue an order approving the Proposed Modification, conditioned upon the trustees' receipt of a favorable letter ruling from the Internal Revenue Service.

State Statute provides that a local court may modify the administrative or dispositive provisions of a trust if, owing to circumstances not known or anticipated by the settlor, compliance with the provisions of the trust would defeat or substantially impair the accomplishment of the purposes of such trust.

On Date 4, Local Court appointed a guardian ad litem to represent the minor beneficiaries, Great-grandchildren A through D, and Son's otherwise unrepresented descendants, born and unborn.

You have requested the following rulings:

1. The Proposed Modification of Trust will not affect the exempt status of Trust for GST tax purposes.

2. The Proposed Modification of Trust will not constitute a gift by any of the current beneficiaries of Trust.

### Law and Analysis

Section 2501 of the Internal Revenue Code imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual.

Section 2511 provides that the gift tax applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 25.2511-1(c)(1) provides that the gift tax also applies to gifts indirectly made. Any transaction, in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Section 2601 provides that a tax is imposed on every generation-skipping transfer made by a "transferor" to a skip person.

Under § 1433(b)(2)(A) of the Tax Reform Act of 1986 and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the generation-skipping transfer tax provisions do not apply to any generation-skipping transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985. However, this exemption does not apply if additions (actual or constructive) are made to the trust after September 25, 1985.

Section 2631(a) provides that for purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption of \$1,000,000 (adjusted for inflation) which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

Section 2651(b)(1) provides that an individual who is a lineal descendant of a grandparent of the transferor shall be assigned to that generation which results from

comparing the number of generations between the grandparent and such individual with the number of generations between the grandparent and the transferor.

Section 2651(b)(3)(A) provides that a relationship by legal adoption shall be treated as a relationship by blood.

Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under § 26.2601-1(b)(1), (2), or (3) (hereinafter referred to as an exempt trust) will not cause the trust to lose its exempt status. In general, unless specifically provided otherwise, the rules contained in § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST or the creation of a new GST. A modification that is administrative in nature that only indirectly increases the amount transferred will not be considered to shift a beneficial interest in the trust.

Section 26.2601-1(b)(4)(i)(E), Example 7, considers the following fact pattern: In 1980, Grantor established an irrevocable trust for the benefit of Grantor's grandchildren, A, B, and C. The trust provides that income is to be paid to A, B, and C, in equal shares for life. The trust further provides that, upon the death of the first grandchild to die, one-third of the principal is to be distributed to that grandchild's issue, per stirpes. Upon the death of the second grandchild to die, one-half of the remaining trust principal is to be distributed to that grandchild's issue, per stirpes, and upon the death of the last grandchild to die, the remaining principal is to be distributed to that grandchild's issue, per stirpes. In 2002, A became disabled. Subsequently, the trustee, with the consent of B and C, petitioned the appropriate local court and the court approved a modification of the trust that increased A's share of trust income. The modification does not shift a beneficial interest to a lower generation beneficiary because the modification does not

increase the amount of a GST under the original trust or create the possibility that new GSTs not contemplated in the original trust may be made. In this case, the modification will increase the amount payable to A who is a member of the same generation as B and C. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust as modified will not be subject to the provisions of chapter 13. However, the modification increasing A's share of trust income is a transfer by B and C to A for federal gift tax purposes.

No guidance has been issued concerning judicial modifications that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

In this case, Son's current descendants, Grandchildren A and B and Great-Grandchildren A through D are the current beneficiaries of Trust. The Proposed Modification would expand the class of individuals who qualify as beneficiaries of Trust to include legally adopted persons who have not reached the age of majority, if adopted by Son or his descendants. If an adoption were to occur, the adoptee would be in the same generation as that of other permissible beneficiaries under the terms of Trust. Thus, like the situation in Example 7, this modification does not result in a shift of a beneficial interest to a lower generation beneficiary at any time during the existence of Trust or of any separate trust created under the terms of Trust. Consequently, the Proposed Modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification. In addition, the modification does not extend the time for vesting of any beneficial interest in the trust beyond the time provided for in the original trust. Therefore, based on the facts submitted and representations made, and assuming that Local Court approves the Proposed Modification and that the Proposed Modification is effective and binding on the beneficiaries, we conclude that the Proposed Modification will not cause Trust to be subject to the provisions of chapter 13.

In addition, Son's current descendants do not include any adopted children. It is represented that Son and his descendants do not currently intend to adopt any children. Therefore, unlike the situation in Example 7 of § 26.2601-1(b)(4)(i)(E), the Proposed Modification will not change the amount of any current beneficiary's interest in Trust. Further, on the date the Proposed Modification becomes effective, none of the current beneficiaries of Trust will have adopted children. Thus, based on the facts submitted and representations made, and assuming that Local Court approves the Proposed Modification and that the Proposed Modification is effective and binding on the beneficiaries, the Proposed Modification of Trust will not constitute a gift by any of the

current beneficiaries of Trust. We recognize that, based on the facts and circumstances at the time of an adoption, a gift may occur when a descendant of Son adopts.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of provides that it may not be used or cited as precedent.

Sincerely,

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Leslie H. Finlow  
Senior Technician Reviewer  
Branch 4  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure

Copy for section 6110 purposes

cc: